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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MAX BARNETT and ESTHER BARNETT, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MICHAEL J. IPPOLITO and AGNES IPPOLITO, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' BRIEF IN REPLY

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Respondent's brief has sought to envelop petitioners' case in a welter of misstatements and irrelevancies. When these are stripped away, it becomes apparent that he has but corroborated petitioners' thesis that the "principle" of the Court below not only conflicts with the view of other Courts of Appeal but is inherently unworkable and mischievous. In espousing it, respondent is really urging this Court to let him say, without objective standard or restraint, who may deduct interest on indebtedness and who may not. Therein lies a real potential for discrimination and for disruption of the market for securities of the United States.

1. Respondent's specious recitals that petitioners "purported" to purchase and "purported" to resell, that they "exercised no dominion over the property" (Resp. 13) trample the simple facts of the case. Respondent's innuendos would apply with equal validity to the many thousands of margin transactions in securities consummated daily, which respondent recognizes for Federal tax purposes. These purchasers never see their securities either; the securities are delivered to banks as collateral for the unpaid balance of the purchase price. The owners see only memoranda which mark their legal rights and obligations. Like other purchasers on margin, these petitioners bought their securities at prevailing market prices and hypothecated their securities for the margin they borrowed through their broker. They had no need or purpose to do anything else. Respondent's attempt to distort the commonplace facts shouts its irrelevance.

Respondent's assertion that the resales of Barnett's and Ippolito's securities "were not the products of any bar-

gaining or consultation" and "were accomplished without prior notice to petitioners" (Resp. 13) is equally without meaning or substance. Elsewhere, respondent concedes that Gibraltar charged petitioners "slightly more" than it paid for the securities (Resp. 4)—in actuality, 1/32 more, the normal dealer's charge for acting. The sales were similarly made at the then market, pursuant to unrecorded telephone orders, as is the everyday custom in the financial community.

Both Gibraltar's officers and the taxpayer's accountant testified categorically that there was no prearrangement of any kind with respect to the transactions (see Appendix). No prearrangement or irregularity of any sort was essential to petitioners' transactions, and none occurred. Respondent's statements are but a pretext—a senseless one, considering that the dealer, Gibraltar, was earning an interest differential of ½%, or more (Pet. Br. 22-26), on the moneys it had borrowed from Cleveland Trust and reloaned to the petitioners. The callow insistence that Gibraltar voluntarily and unilaterally deprived itself of this income is not only contrary to the testimony that there were no prearrangements—i.e., giving Gibraltar the right to sell petitioners' securities—but to the reasonable inference that the dealer would not act against its own interest.

Respondent, innocently or deliberately, confuses the instant case with others, of which he cites in a whole array (Resp. 12-13), which are distinguishable in a single overriding fact: In each, the broker funded the taxpayers' transactions *by selling the same securities short,* delivering the taxpayers' securities against its sale and applying the proceeds to pay for the securities the taxpayers had bought. The short sales were imputed to the taxpayers

by the Courts, nullifying their investments (see *Stanton* v. *Comm.*, 34 T.C. 1, 9; *MacRae* v. *Comm.*, 34 T.C. 20, 27). In the instant cases, there was no such nullification; the securities purchased by the petitioners remained in the hands of the lender banks throughout the duration of the subject transactions and the banks' money remained committed to petitioners' transactions. Since it is inconceivable that respondent cannot recognize this all-important distinction, it is apparent that what respondent really objects to, under all the smokescreen, is the avoidance of tax, and that he seeks to bar such avoidance even when achieved through valid transactions.

Petitioners have done what they, like all other taxpayers, have a right to do—purchase government securities and put them up as collateral for a loan. They had no need for any devices or sham to accomplish their purpose. If they had, through senseless masochism, resorted to unneeded devices, the far-reaching issue their cases present would still abide, its ghost unlaid.

The real core of petitioners' cases lies in the fact that they paid more to carry their United States securities than those securities, in turn, yielded them. Respondent would raise dire implications from this, but the inexorable fact is that the yield petitioners obtained was the yield *everyone* received who purchased the particular securities at the same respective times; and the price petitioners paid for their borrowing was the going rate for loans from banks at that time. Of course, the two are not the same. The yield of United States securities represents the basic or "pure" rate of interest. Banks pay their depositors more than this rate and, of course, they must make a profit on their lending operations. The "prime rate" of interest at

present, charged by banks to the best-rated customers is 6% (and very few can borrow at this rate); the New York Times for December 27, 1966 shows that yields on United States securities the previous day ranged from 4.02 to 4.93%

Respondent seeks to distinguish the *Stanton* case from the instant cases (Resp. 12, Fn. 8), yet he cooly ignores the fact that Stanton, a member of the New York Stock Exchange, had to pay 3% interest to the banks on his $5,000,000 borrowings, approximately twice the yield of 1.55% afforded by the United States Treasury Notes he had purchased, and which had but two years to run to maturity.

Respondent would distinguish *Stanton* on the Tax Court's finding there in that his "Treasury notes transactions would have been profitable before taxes if events had happened as he anticipated . . . " (that is, if the banks had permitted Stanton to prepay notes that contained no prepayment clause). Respondent therein makes petitioners' case. Stanton's experience demonstrates that profit apart from taxes is possible through the swing of the market for United States securities; petitioners' securities were traded in that same market and they too might have had a pre-tax profit, had the market gone right. Surely, respondent would not have the interest deduction hinge on the hind-sight fact that Stanton could have had an actual profit. (Petitioner Barnett herein would have had a pre-tax profit had he had the foresight to hold his bonds an additional month. But that is irrelevant.) These petitioners, like Stanton, borrowed hard cash from banks to pay for property purchased and one borrowing was "indebtedness" like the other.

2. The issue here is whether the petitioners' presumed motive disqualifies their indebtedness. There are no adequate standards in the opinions below, or elsewhere, by which a person's motives may be truly weighed in these particular circumstances, wherein a taxpayer understands that any loss sustained will be salvaged by the interest deduction. *It must be presumed* in these circumstances that the taxpayer knows about the effect of the deduction and has acted with normal self interest in the expectation that his loss will be redeemed.

The opinions below provide no objective standard by which the Courts, much less a Revenue Agent in the field, may distinguish validly between fair and foul, the pure-minded and the base-minded. Respondent has recognized this in terms, although perhaps not its implications. Arguing that the principle of these cases "is essentially a restatement of the core of the *Knetsch* ruling", he continues (Resp. 9):

> "The principal difference is that the instant opinion would allow a deduction when a transaction *does not comply with objective* standards yet the taxpayer had actually believed that there was a real possibility of economic benefit . . . " (emphasis supplied).

Respondent fails to recognize that the law cannot be administered fairly without objective standards; that it is impossible to know with any valid degree of certainty what a Stanton "actually believed" in this situation any more than what a sweepstake winner—or the ordinary investor—believed, whether one was motivated by the certain knowledge of redemption from loss by the interest deduction and

the other not. With this admission as to the true meaning of these cases, respondent stands before this Court as one asking *carte blanche* to say who shall have the interest deduction and who not . . . in short, to discriminate against a class of taxpayers like these petitioners and who ever else might grate upon his partisan sensibilities—or else, wholly to nullify section 163 in so far as it would apply to obligations of the United States by refusing the deduction to all who must pay 7% interest (the present margin rate) to support a yield of 4½% on such securities.

Respondent's own candid expression of the meaning of these cases reveals the urgency of intervention by this Court.

3. Having conceded that the test in this case is not grounded on any objective standards, respondent at once tries to distinguish *Fabreeka Products, Inc.* v. *Comm.*, C. A. 1, 294 F. 2d 76 (which petitioner has shown to be in conflict with this case (Pet. 16-17)), in that Fabreeka's "purchase and ownership of the bonds did not lack substance under objective standards" (Resp. 13).

That was not what respondent argued in *Fabreeka;* there, as here, he argued the transactions were "sham". But here, as in *Fabreeka,* the taxpayers purchased securities just as thousands of taxpayers do everyday, with full legal effect. The real core of respondent's position is clearly revealed in this argument. It is not any lack of substance in petitioner's purchase and ownership of the securities or lack of reality in the borrowing to pay the purchase price that taints the transactions for respondent. The tax avoidance motive is the real burr. There the ultimate issue rests. On that issue, the conflict between the cases is clear and undeniable.

That the identical issue has arisen on variant facts and statutory provisions attests its pervasive importance. Notably, respondent has not challenged petitioners' demonstration of that importance, made crucial by the unrealistic and mischievous "principle" adduced by the Court below. The importance of the question—for the market in securities of the United States and for investors, as well as for these taxpayers and for the orderly administration of the revenue—solicits the hearing of the within cases by this Court.

CONCLUSION

For the reasons stated, the petition for writs of certiorari should be granted.

Respectfully submitted,

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APPENDIX

Excerpts From the Record*

* * * * *

(Direct examination of Mr. Jack Bernstein, Vice-President of the dealer, Gibraltar Financial Corp.)

Q. Mr. Bernstein, were there any oral commitments, understandings or arrangements at that time—and I fix the time as on or about December 23, 1955, give or take back or forward several days—between Gibralter and Mr. Ippolito or anybody representing Mr. Ippolito as to how long Mr. Ippolito was going to hold those bonds or maintain its loan account with you? A. No.

* * * * *

* * * * *

Q. When you talked with Mr. Bourne on the telephone, did you give him any assurances that the amount of the loan would be shortly liquidated by Gibralter Financial

Corporation? A. I can't recall that assurance, no, sir.

* * * * *

(Direct examination of Mr. Milton Zipper, C. P. A., accountant for petitioners Barnett and Ippolito)

* * * * *

Q. Mr. Zipper, at the time that you placed the order with Gibralter for the purchase of Treasury Certificates, did you have any commitment, understanding, arrangement

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* *Ippolito* v. *Comm.* It was stipulated in the *Barnett* case that the proof in *Ippolito* applied to it as well.

or any similar indication to Gibralter or Mr. Bernstein as

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to how long your client was going to hold those bonds, those certificates, or how long the loan would remain in force, and I place, I fix, the time as on or before December 23rd, the date when the order was placed. A. There was no arrangement other than the fact that the note itself ran for one year.

Q. Was there any arrangement to terminate sooner than one year? A. No, not at the time of purchase.

Q. Was there any arrangement to terminate when the bonds or certificates hit a specific price?

Mr. Kamp: I object, your Honor, on leading questions. He has been leading the witness. I would rather have the witness testify to it of his own knowledge.

The Court: The objection is overruled. Proceed.

Mr. Delson: Would you read the last question, please?

(Question read.)

A. No.

Q. I ask you that same question, Mr. Zipper, now fixing the point in time to December 27, 1955, which was the date shown on the note which the petitioner here executed. Was there any arrangement at that time when the signed notice was transmitted to Gibralter? A. No.

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